

# Internal Control: Supplement on Internal Auditing

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## Section A.1010.1

The information in this section is reprinted from a publication of the Bank Administration Institute (BAI), entitled "Statement of Principle and Standards for Internal Auditing in the Banking Industry."

### A STATEMENT OF PRINCIPLE CONCERNING INTERNAL AUDITING IN THE BANKING INDUSTRY

Internal auditing is that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control within an organization and the quality of ongoing operations.

The systems of control comprise the plan of organization and all methods and measures designed to:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and corrected promptly.
- Promote operational efficiency.
- Encourage compliance with managerial policies, laws, regulations, and sound fiduciary principles.

Ongoing operations comprise all activities involved in the conduct of the organization's business.

The internal auditor is accountable to the board of directors and executive management. This accountability precludes the auditor from organizational relationships that may conflict with the need for independence.

### STANDARDS OF INTERNAL AUDITING IN THE BANKING INDUSTRY

#### Organization Standards

1. The organization shall have an internal audit function responsible for evaluating the adequacy, effectiveness and efficiency of its systems of control and the quality of ongoing operations.

2. The organization shall maintain an environment within which the auditor has the freedom to act.
3. The organization shall allocate sufficient resources to the audit function to enable it to conform to the standards of internal auditing.
4. The organization shall require management to respond formally to adverse audit findings and to take appropriate corrective action.
5. The organization's systems of control shall include measurement of audit effectiveness and efficiency.

#### Personal Standards

1. An internal auditor shall have adequate technical training and proficiency.
2. An internal auditor shall maintain a sufficiently independent state of mind to clearly demonstrate objectivity in matters affecting audit conclusions.
3. An internal auditor shall respect the confidentiality of information acquired while performing the audit function.
4. An internal auditor shall only engage in activities that do not conflict with the interests of the organization.
5. An internal auditor shall adhere to conduct that enhances the professional stature of internal auditing.
6. An internal auditor shall exercise due professional care in the performance of all duties and in the fulfillment of all responsibilities.

#### Performance Standards

1. The internal auditor shall prepare a formal audit plan that covers all significant organizational activities over an appropriate cycle of time.
2. The audit plan shall include an evaluation of controls within new systems and significant modifications to existing systems before they become operational.
3. Audit procedures shall provide sufficient and competent evidential matter to support conclusions regarding the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.
4. The organization of the audit function and

related administrative practice shall provide for the proper supervision of persons performing audits and for the proper review of work performed.

## Communication Standards

1. The auditor shall prepare a formal report on the scope and results of each audit performed.
2. Each audit report shall contain an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control; or an explanation of why an opinion cannot be expressed. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.
3. The auditor shall communicate audit findings in a timely manner to the managers responsible for corrective action.
4. At least once each year the auditor shall make a summary report of audit activities to the board of directors and executive management. The report shall include an opinion on the overall condition of the organization's controls and operations.

## COMMENTARY

The following comments are presented in order to promote the acceptance of the "Statement of Principle and Standards for Internal Auditing in the Banking Industry," to provide a context for the application of its concepts and to enhance the understanding of internal auditing. It is intended that the statement and the commentary will serve as a basis for the continuing advancement of the profession's influence and service.

## Internal Auditing as a Discipline

Internal auditing is developing a broader perspective by recognizing that all operations are properly subject to control and within the scope of auditing. The internal auditor's concern for control should extend beyond accounting matters. This broader concept better serves the board of directors and executive management to whom the internal auditor is accountable. Bank Administration Institute believes the systems of

control and ongoing operations, as defined herein, provide a preferred perspective for discussing internal auditing within the framework of the auditing discipline taken as a whole.

## Concepts of Control

The systems of control exist to assure the achievement of intended results, to promote operating efficiency and to encourage compliance with policies and other established constraints. Although internal auditors have a definite interest in verifying the results of business activity, their primary concern must be the continuing effectiveness of the systems of control that influence business results. The important qualities that must be evaluated are adequacy, effectiveness and efficiency.

In evaluating adequacy, the auditor analyzes systems to determine that they include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial audits and audits of proposed procedures or organizational structures focus primarily on the adequacy of control.

In evaluating effectiveness, the auditor measures the degree of compliance with control features and the extent to which compliance serves the intended purposes. The question that must be answered is: "Do the controls work?"

In evaluating efficiency, the auditor judges the practicality of controls in terms of their cost relative to their intended benefit. It is not intended that the auditor should evaluate adequacy or effectiveness in absolute terms, nor is it intended that the auditor judge efficiency in absolute terms. An internal auditor's evaluation of efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, the internal auditor must conclude whether the benefits provided by the controls exceed their cost.

The systems of control and not the audit function:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.

- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations and sound fiduciary principles.

Those members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. Internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Controls act as a positive force to facilitate successful operations as well as a negative one that restricts activities. Accordingly, the auditor should evaluate control systems in terms of the incentives they provide as well as the sanctions.

Safeguarding assets relates to physical, legal and all other protective means by which the organization assures the full realization of its resources.

All information should be subject to the systems of control. Timely information is that which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decision because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

The systems of control must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls.

The systems of control should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to select and train personnel, establish procedures, set performance requirements, measure results and provide incentives.

Managerial policies, laws, regulations and sound fiduciary principles establish bounds within which the organization can conduct its business. The features of the control system that encourage compliance with these requirements include the separation of duties, the employment of persons likely to comply, the establishment of authority limits and the communication of expected conduct.

## Ongoing Operations

Management must evaluate the quality of operations based on information provided by the control systems. Adequate control systems produce sufficient information to reliably appraise operations. To confirm that the control systems are adequate and effective, the internal auditor should independently evaluate the quality of ongoing operations. Only ongoing operations have future significance.

Internal auditors should express their opinion on whether the quality of ongoing operations is satisfactory or unsatisfactory. Satisfactory operations are those which, in the opinion of the auditor, require no extraordinary intervention by executive management or the directors. Conversely, unsatisfactory operations require extraordinary intervention before appropriate remedial action is likely to occur. A qualified opinion may be expressed by citing specific exceptions to satisfactory operations. Auditors may assess the quality of operations more precisely and report on grades of quality, provided the grades are clearly understood by management.

Circumstances may preclude the auditor from forming an opinion on the quality of ongoing operations. This, by itself, is significant because the information provided by the control systems should be adequate for the evaluation of ongoing operations.

## Accountability

Accountability refers to the measures of effective audit performance. The organization standards of this statement define the conditions necessary to hold the auditor accountable for the other standards.

Only the board of directors can protect the auditor's need for independence; consequently, the board should be the final judge of the auditor's performance. The fact that the process of measurement may be done through an audit committee does not alter the auditor's ultimate accountability to the board.

Both the auditor and executive management have received a delegation of authority from the board: management to design and maintain systems of control; the auditor to evaluate these systems of control. Because the evaluation process exists to serve the design and maintenance responsibility, the auditor must also be account-

able to executive management. This accountability, however, does not create the usual corollary right of the executive to directly apply sanctions or to otherwise restrict the auditor's functional independence. Such action, if necessary, must be decided by the board.

The auditor should be mindful that the audit function serves many users. The auditor has an obligation, if not accountability, to those users. The auditor's personal relationship with others should be characterized by integrity, open communication and mutual respect. User satisfaction should be an important consideration in the board's evaluation of audit performance.

Independence is a matter of personal quality rather than of rules. The auditor's relationships, as indicated by the plan of organization and by the way in which the work is conducted, must always be such that a presumption of independence logically follows in the mind of the observer.

## Organization Standards

A banking organization can best evidence its support and commitment to the professional standards of internal auditing by formally adopting these standards.

The organization standards are prerequisites to the personal, performance and communication standards. They simply state that an internal auditor cannot be accountable for adherence to the other standards without the necessary resources and support of the organization.

Many banks cannot afford the services of a competent and independent internal auditor. It should be clearly understood that those banks are not in compliance with these standards. Their directors and executive management, therefore, bear the burden of providing additional supervision to assure the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.

The organization shall provide and maintain an environment within which the internal auditor has the freedom to act. Persons whose duties and responsibilities are subject to audit cannot have the authority to regulate the scope of audit work nor the procedures considered necessary by the auditors. The auditor's responsibility to independently evaluate the systems of control must carry with it the authority to set the scope and choose the means of examination.

Budgeting should be based on a complete plan of audit that demonstrates fulfillment of the organization's audit needs and adherence to the standards of internal auditing. In committing resources to the internal audit function, the organization should expect the auditor to properly support requested allocations through the established budget process.

The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, the organization contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention.

The organization should measure the performance of its internal audit function in relation to the timeliness, efficiency and the quality of its work. Timeliness is indicated by scheduling the work in recognition of risk assessments and by the prompt issuance of reports. Efficiency is indicated by completing the work within the time budgeted. An efficient internal audit program also minimizes the time required by examiners and public accountants without affecting adequate coverage. Formal work programs, workpapers and the form and content of reports evidence the quality of an audit function. The organization should consider using the opinions formed by bank examiners, certified public accountants and other professional auditors to assist in this performance evaluation. Smaller banks may find the services offered by their correspondents include such evaluations.

## Personal Standards

Personal standards relate to the qualifications of auditors, the quality of audit practice and the rules of professional conduct. They concern all persons who apply audit procedures under a delegation of authority from the board to support conclusions regarding the systems of control. Personal standards are prerequisites to performance and communication standards.

All persons engaged in the practice of internal auditing shall have the technical training and proficiency necessary to conduct their audit duties in accordance with these standards. Technical training and proficiency are separate requirements. Technical training relates to education; proficiency relates to the skill and judgment acquired through experience.

The qualified internal auditor will have successfully completed a course of study and training in disciplines having audit significance and will understand their application to banking. These disciplines include the principles of accounting, auditing, economics, finance, operations analysis, management, statistics, commercial law and computer science.

Experience is gained by working under the close supervision and review of an experienced professional. This relationship should make the job itself a vehicle for seasoning and refining the technical training acquired through formal education. On-the-job training should be carefully planned and organized. Those responsible for managing the audit function should define the elements of knowledge and judgment that may be gained from experience and establish a way to measure the resulting proficiency.

Proficiency is demonstrated by the proper exercise of professional judgment. It is difficult for users of professional services to accurately assess proficiency. Therefore, recognized professions, including internal auditing, provide certification programs for their practitioners. Each person engaged in the internal audit function can demonstrate proficiency by earning a professional designation such as chartered bank auditor, certified internal auditor or certified public accountant. The last two designations, however, require successful banking or related experience to demonstrate a practical knowledge of the industry.

The modern business environment demands that an internal auditor maintain proficiency by active participation in programs of continuing education and professional association.

There is no concept more important to internal auditing than independence. The essence of independence is intellectual honesty informing conclusions and expressing opinions. Conclusions must be reached fairly without bias or the propensity to prejudice circumstances. Opinions must be expressed forthrightly despite the conflicts that may arise. Although the appearance of independence relies on a plan of organization that grants the auditor freedom from conflicting accountabilities, the actual attainment of independence depends solely on the individual. The concept of independence is most fundamental to the definition and practice of auditing.

Independence is not isolation. Auditors should not allow their need for independence to inhibit the contacts and rapport necessary for a fully effective audit function.

Banking organizations properly require all employees to honor the confidentiality of financial and other information obtained during their employment. This requirement is all the more important for internal auditors because of the nature and scope of their work. Confidentiality also applies to the judicious use of information within the organization.

An internal auditor should not accept employment or participate in activities that compete or otherwise oppose the lawful objectives of the organization. Loyalty reflects integrity and credibility. Relationships which may, even by implication, raise doubt concerning the auditor's loyalty to the bank therefore must be avoided.

All members of a profession owe allegiance to their colleagues. The reputation of all depends to some degree on the conduct of each. Internal auditors develop professional recognition by supporting and participating in associations organized to serve their common needs. Each internal auditor is also obligated to maintain proficiency and awareness through self-education.

Due professional care imposes an ethical obligation on all auditors to demonstrate competency. Due care acts as a safeguard against negligence and oversight. Due professional care applies to the administrative practices that bear on the quality of audit results as well as to the use of audit procedures that provide sufficient competent evidence.

Due professional care is a subjective standard based on reasonableness. The duty of due professional care requires the auditor to know the extent of reliance that others within the organization place on audit results. When such reliance is unrealistic or misunderstood, the auditor should resolve the misunderstanding and temper unrealistic expectations.

The organization should require the presentation of audit findings in a manner that convinces management that the auditor exercised due professional care.

## Performance Standards

The audit plan should be written and presented in a form that is suitable for critical review by audit committees, certified public accountants, regulatory examiners and others who must evaluate the adequacy of audit coverage.

An audit plan is based on a catalog of examinations that includes all significant activities of the organization classified by logical

units for work scheduling. For example, demand deposit bookkeeping functions may be classified as three separate audits: overdraft control practices, confirmation of balances and bookkeeping operations.

The frequency of audit should be determined by reference to factors affecting risk, management information, customer satisfaction and the need to create an awareness of audit presence. Risk assessment involves audit judgment regarding how often and to what extent the systems of control must be evaluated.

In mature audit operations, the problem of balancing audit objectives with audit resources has usually been solved. Risk assessment in the context of audit planning does not normally change in the near range. The audit plan for each cycle does not prescribe a detailed listing of tests and procedures to be applied. These tactical steps are to be found in the work program.

The audit plan, which usually represents work contemplated for the current year, should present the information necessary to schedule and assign the work. It should cover resources requirements, administrative goals and objectives and the estimated costs of audit. Resource plans identify the number of persons needed, schedule their time (including such non-audit time as administration, vacation, lost days, staff training) and specify the level of ability. Administrative goals and objectives should reflect the audit implications of conditions that influence the organization. Audit costs should be identified in sufficient detail to encourage the audit manager to justify their cost and impact on the organization.

While cost justifying the audit plan, the auditor should recognize that the organization's cost of control includes its cost of auditing. In certain areas, efficiencies may best be achieved by strengthening the control systems as an alternative to audit coverage.

The audit plan shall include an evaluation of the adequacy of controls within new systems and significant modifications to existing systems before they become operational. This evaluation should include the controls designed into the conversion plan. Significant modifications are those that affect controls to an extent that audit concern is created regarding the organization's resulting exposure to loss.

The second performance standard concerns the timing of audit but not its scope. Identifying significant changes and establishing audit procedures is a matter of individual audit judgment. Modern complex systems are expensive to

develop and maintain. Building adequate controls within the original design is usually less costly than adding them after the system is operational. The cost of evaluation, however, is usually no greater before implementation than after.

The reliability of audit results depends on the character of supporting evidence. Audit procedures should be selected and applied in a way that assures such evidence is sufficient and competent.

The term "sufficient" as used here means that enough evidence is assembled to assure that audit conclusions are well founded. The internal auditor's determination of what constitutes enough evidence is a matter of professional judgment relative to the controls and operations under evaluation. Frequently, sufficiency can be demonstrated by the application of statistical sampling techniques.

The term "competent" means relevant and valid. Competent evidence has the requisite ability to convince. Both the substance and the interrelationship of evidence demonstrate competence. Whereas sufficient is a quantitative concept, competent is a qualitative one.

Competency for audit purposes depends on the procedures used to obtain evidence. Direct knowledge, such as obtained by observation or inspection, is more reliable than indirect knowledge, such as obtained by confirmation and inquiry. Obtaining the most competent evidence, however, is not always feasible. Selecting and applying those procedures that collectively produce the most competent evidence under the circumstances demonstrates audits proficiency.

Audit work should be organized so that the objectives at each level of detail are clearly defined. Each phase of the work as well as the contribution of each person should be viewed by a superior. Audit management should review the audit programs, questionnaires and other planning features for completeness, applicability and efficiency. The reviewer should be satisfied that those who perform field work understand the systems under examination and the audit procedures that have been selected for application.

The auditor in charge of each assignment should perform a detailed review of the work as it is completed. No work should be accepted unless it complies with the standard of evidence. Audit management should conduct a comprehensive final review of the workpapers to determine that proper procedures were applied, sufficient evidence was assembled and all excep-

tions were properly evaluated in terms of their control significance. Audit management should also make interim field reviews.

Reviews must be documented. All auditors should appreciate the importance of the review process and perform their work in a manner that facilitates review. Review serves as an educational process as well as a control. Directors of banks employing only one auditor should supervise the auditor's work in a manner that provides a check on audit quality.

## Communication Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively and efficiently. By implication, audit reporting only on an exception basis extends the auditor's responsibility beyond what the actual work can support and causes misunderstanding.

Requiring auditors to express an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations enables the board of directors, management and other interested parties to better judge the reliability of the control systems and ongoing operations. This service is a natural and logical part of the internal auditor's accountability.

Expressing an opinion imposes a serious obligation on the auditor. The requirement of due professional care extends to both the opinion and the commentary supporting it. Clear identification of the systems of control audited is the key to a meaningful opinion.

Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action.

It is suggested that auditors develop their opinion statement along the following lines:

"In our opinion (the audit subject's) operating and accounting procedures include those practices usually necessary to provide adequate and efficient control. Also in our opinion, the degree of compliance with such procedures provided effective control during the (period of audit). We found the quality of ongoing operations satisfactory."

This opinion assumes the auditor has reviewed the systems of control before they became operational and is satisfied that they include design features proper to the circumstances and reasonably sufficient to effect control. The second sentence of the opinion addresses the degree of compliance with control features previously found adequate and efficient. Audits of operations that are subject to a common control system such as a typical branch bank audit need not include a review of the system each time a unit audit is performed. The auditor, however, should be satisfied that all modifications to the existing system that significantly affect control have been evaluated.

Auditors occasionally form adverse conclusions concerning the adequacy, effectiveness or efficiency of the systems of control or the quality of ongoing operations. In these cases, they should qualify their opinion and identify exposures that may exist in the absence of corrective action. Risk measures the degree to which exposures are uncontrolled. The applicable equation is: Exposure minus control equals risk. A calculated risk is taken only when the exposure is fully identified and the implications of the lack of control are understood. To make an adverse opinion clear and meaningful, therefore, the auditor must identify relevant exposures and explain their significance.

Every audit report should identify the area audited and disclose all matters the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Some managements prefer to have all audit findings reported no matter how minor. Others prefer only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of executive management and the board of directors.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that many managements expect suggestions for corrective action, particularly when the technical aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

A draft of each audit report should be made available to the manager of those operations under examination. Findings should be discussed with the manager before final issuance of the report. Any revisions should be similarly reviewed. The final report must clearly present audit findings and avoid language that may imply a meaning inconsistent with the supporting evidence. A review and a discussion of the draft assure this result.

Auditors must establish the facts of their findings but do not have to obtain complete management acceptance of their comments before issuing a report. Auditors should be prepared for occasional conflict and disagreement.

The ease with which auditors can retrieve information, support fact and amplify findings validates the adequacy and the quality of audit evidence. The extent to which auditors gain acceptance of their comments ultimately measures the effectiveness of internal auditing's contribution to the organization.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation of a formal report. Findings should be communicated to the manager whose operation is directly affected.

The extent and frequency of audit reports required by the board of directors varies with the organization. At least annually, however, the auditor shall formally report to the board of directors and executive management. The board of directors and executive management are entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to pro-

mote an understanding of the audit function and how it serves the organization.

In the summary report, the auditor should express an opinion on the overall condition of the organization's controls and ongoing operations. The report should present all known control problems of significance as well as an evaluation of corrective action taken. Although the report is formal, it should be presented personally to ensure proper interpretation and to provide the benefit that flows from the exchange of information and concerns.

## Fraud and the Auditor's Responsibility

The auditor is charged with understanding the purposes of the business, the control practices usually necessary to achieve them, and the type of evidence that indicates they will continue to be achieved. The following questions are prerequisite to evaluating the systems of control: What is the purpose of the system? How is it controlled? What can go wrong?

Audit proficiency includes the ability to evaluate fraud exposures. Sufficient information is available in the literature on auditing concerning how frauds may be committed in banking. The auditor should be familiar with that literature.

The systems of control and not the internal audit function provide the primary assurance against fraud. Internal auditors, however, must evaluate the capability of the systems to achieve that end. When in doubt, the auditor should consider applying additional procedures to determine if fraud has actually occurred.

In fixing the internal auditor's responsibility for detecting fraud, it should be recognized that the internal auditor cannot be responsible for detecting irregular transactions for which there is no record, e.g., an unrecorded receipt of cash from a source for which there is no evidence of accountability; an isolated transaction that does not recur, e.g., a single fraudulent loan; or irregularities that are well concealed by collusion. However, in the usual course of the audit cycle, the internal auditor should detect irregularities that significantly affect the financial statements, repeatedly follow a suspicious pattern of concurrence, or those that can be detected by a reasonable audit sampling. Internal auditors must also accept responsibility for those irregularities that result from their failure to report known weaknesses in the systems of control.



In judging the preventive capacity of the control systems and the internal auditor's responsibility, the principle of relative risk should not be ignored, namely, costs must be balanced against intended benefit.

## CONCLUSION

Professional internal auditors can contribute a wealth of information to their organizations over and above the assurance they provide by evalu-

ating the quality of control systems and ongoing operations. The word, "audit," comes from the Latin word, *audire*, meaning to hear. Internal auditors should be good listeners and observers. They should demonstrate an in-depth understanding of the strengths and weaknesses of the organization, the accomplishments and current problems of its departments, the quality of its services, the pride and concerns of its people and the efficiencies and diseconomies of its operations. In turn, executives and directors should listen to professional internal auditors and capitalize on their observations.

# Cash Accounts: Financial Recordkeeping and Reporting Regulations— Examination Procedures

Section A.2000.1

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The material in this section has been incorporated into the *Bank Secrecy Act Examination Manual*.

# Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System

Effective date May 1997

Section A.5020.1

## OVERVIEW

Since 1979, state member banks have been rated using the interagency Uniform Financial Institutions Ratings System (UFIRS), which was recommended by the Federal Reserve and other banking agencies. This rating system, referred to industry-wide by the acronym CAMEL, evaluated five components: capital adequacy, asset quality, management and administration, earnings, and liquidity.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for uniformly evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. Recently, the UFIRS was revised and updated to address changes in the financial services industry and in supervisory policies and procedures. The revisions include the addition of a sixth component addressing sensitivity to market risks, explicit reference to the quality of risk-management processes in the management component, and identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions nor require additional policies or processes. Instead, they are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original system.

The UFIRS considers certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated comprehensively and uniformly and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS is a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system helps Congress follow safety-and-soundness trends and assess the aggregate strength and soundness of the financial industry, which helps the federal banking agencies in fulfilling their collective mission of

maintaining stability and public confidence in the nation's financial system.

## COMPOSITE RATINGS

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1-to-5 numerical scale. A "1" is the highest rating, indicating the strongest performance and risk-management practices and the least degree of supervisory concern. A "5" is the lowest rating, indicating the weakest performance, inadequate risk-management practices, and the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and address the risks that may arise from changing business conditions or the initiation of new activities or products is an important factor in evaluating a financial institution's overall risk profile, as well as the level of supervisory attention warranted. For this reason, the management component is given

special consideration when assigning a composite rating.

Furthermore, the ability of management to identify, measure, monitor, and control the risks of its operations is taken into account when assigning each component rating. Examiners should recognize, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk-taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Examiners consider foreign branch and specialty examination findings and the ratings assigned to those areas, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk-management practices, relative to the institution's size, complexity, and risk profile, and the level of least supervisory concern. A rating of 5 indicates the most critically deficient level of performance; inadequate risk-management practices relative to the institution's size, complexity, and risk profile; and the level

of greatest supervisory concern. The composite ratings are defined below.

## Composite 1

Financial institutions with a composite 1 rating are sound in every respect and generally have components rated 1 or 2. Any identified weaknesses are minor and can be handled routinely by the board of directors and management. These financial institutions are the most capable of withstanding fluctuating business conditions and are resistant to outside influences, such as economic instability in their trade area. These institutions are in substantial compliance with laws and regulations. As a result, they exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

## Composite 2

Financial institutions with a composite 2 rating are fundamentally sound. For a financial institution to receive this rating, generally none of its component ratings should be more severe than 3. Only moderate weaknesses are present, and the board of directors and management are capable of and willing to correct them. These financial institutions are stable, can withstand business fluctuations, and are in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

## Composite 3

Financial institutions with a composite 3 rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness

to effectively address weaknesses within appropriate timeframes. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

## Composite 4

Financial institutions with a composite 4 rating generally exhibit unsafe and unsound practices or conditions. They have serious financial or managerial deficiencies that result in unsatisfactory performance. The institution's problems range from severe to critically deficient, and weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means formal enforcement action is necessary in most cases to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure of the institution is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

## Composite 5

Financial institutions with a composite 5 rating exhibit extremely unsafe and unsound practices or conditions. Their performance is critically deficient and risk-management practices are inadequate relative to the institution's size, complexity, and risk profile. These institutions are of the greatest supervisory concern. The volume and severity of problems are beyond

management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and their failure is highly probable.

## COMPONENT RATINGS

Each of the component rating descriptions below lists the principal evaluation factors that relate to that component and briefly describes each numerical rating for that component. Some of the evaluation factors appear under one or more of the other components to illustrate the interrelationship among the components. The evaluation factors for each component are not listed in any particular order.

### Capital Adequacy

A financial institution is expected to maintain capital commensurate with its risks and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the need to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences of these risks on the institution's capital.

The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of capital and the overall financial condition of the institution
- the ability of management to address emerging needs for additional capital
- the nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves
- balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities

- risk exposure represented by off-balance-sheet activities
- the quality and strength of earnings, and the reasonableness of dividends
- prospects and plans for growth, as well as past experience in managing growth
- access to capital markets and other sources of capital, including support provided by a parent holding company

### *Ratings*

1—A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2—A rating of 2 indicates a satisfactory capital level relative to the institution's risk profile.

3—A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4—A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5—A rating of 5 indicates a critically deficient level of capital. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

### *Asset Quality*

The asset-quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance-sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the institution's exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks

that may affect the value or marketability of an institution's assets, including but not limited to operating, market, reputation, strategic, or compliance risks, should be considered.

The asset quality of a financial institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of underwriting standards, soundness of credit-administration practices, and appropriateness of risk-identification practices
- the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance-sheet transactions
- the adequacy of the allowance for loan and lease losses and other asset valuation reserves
- the credit risk arising from or reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit
- the diversification and quality of the loan and investment portfolios
- the extent of securities underwriting activities and exposure to counterparties in trading activities
- the existence of asset concentrations
- the adequacy of loan and investment policies, procedures, and practices
- the ability of management to properly administer its assets, including the timely identification and collection of problem assets
- the adequacy of internal controls and management information systems
- the volume and nature of credit-documentation exceptions

### *Ratings*

1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.

2—A rating of 2 indicates satisfactory asset-quality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit-administration and risk-management practices.

4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit-administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

## Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities, and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of

an appropriate audit program and internal control environment; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability in relation to all aspects of banking operations as well as other financial-service activities the institution is involved in.

The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of oversight and support of all institution activities by the board of directors and management
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products
- the adequacy of and conformance with appropriate internal policies and controls addressing the operations and risks of significant activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and risk profile
- the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies
- compliance with laws and regulations
- responsiveness to recommendations from auditors and supervisory authorities
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- reasonableness of compensation policies and avoidance of self-dealing
- demonstrated willingness to serve the legitimate banking needs of the community
- the overall performance of the institution and its risk profile

## Ratings

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the

institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

## Earnings

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses. High levels of market risk may unduly expose the institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based on, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to operations
- the adequacy of the budgeting systems, forecasting processes, and management information systems in general
- the adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- the exposure of earnings to market risk such as interest-rate, foreign-exchange, and price risks

## Ratings

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to



asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

## Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that

liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and contingency funding plans

## Ratings

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.

3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may show significant weaknesses in funds-management practices.

4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

## Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to the level of market-risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For other institutions, trading activities are a major source of market risk.

Market risk is rated based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

## Ratings

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3—A rating of 3 indicates that control of market-risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4—A rating of 4 indicates that control of market-risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5—A rating of 5 indicates that control of market-risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

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